

FOMC Briefing
SHAxilrod
7/8/85

The main problems in reassessing the long-run targets for 1985 rather clearly focus on M1. There are some issues to consider first with the broader aggregates, though. M2 and credit are currently running around or above their long-run ranges. We do, however, expect M2 to grow within its present range for the year, unless interest rates drop significantly further. Credit growth will probably be around the top of its range, explainable by continued strength in merger and other refinancing activities as well as by expansion of spending in excess of GNP, factors at least partly taken into account by the Committee in setting the range in February. Thus, while the Committee might wish to consider upward adjustments in the upper limits of those ranges, the technical need seems marginal. Another consideration would be whether it might not in any event be better to leave the broader ranges unchanged as something of an anchor in face of the seeming need to make some adjustment in M1.

The materials sent to the Committee attempt to explain both the arithmetic and economic problems in setting an M1 range. The arithmetic says that to attain the 7 percent upper limit of the present M1 range, the aggregate will have to remain essentially flat, on balance, over the rest of the year. It seems likely that M1 growth will indeed slow from the about 11-1/2 percent rate that obtained from December to June. However, short of a large rise of interest rates in the coming six months, the odds do not suggest that demands for money in the period between now and year-end have already been satisfied by the rapid M1 expansion of recent months and that, therefore, little or no further

growth will be needed. For one thing, we are still expecting that the lagged effects of recent interest rate declines will stimulate growth for the months ahead. For another, some of the increase in M1 in the first half of the year represents funds shifted into NOW accounts for long-run savings purposes in response to market rate movements and thus in effect would not be employed to finance growing transactions demands for cash.

If the Committee were to take the view that the existing 4 to 7 percent M1 range was either not practically attainable or no longer desirable, there is the question of course of how to adjust it. One alternative is simply to set M1 aside for a while, at least until it becomes clear that this latest burst of rapid growth is over and that the aggregate's velocity has stopped declining and is returning to a positive rate of growth that our models suggest represents historical trend (abstracting from the effect of interest rates). I should mention at this point, though, that if interest rates need to decline from current levels to sustain real economic growth you can expect that velocity growth will be held down below trend and may often be negative.

However that may work out, there are probably considerable disadvantages under current circumstances in abandoning an M1 range. There may be certain public relations problems, including the risk of promoting fears that the Committee has become less concerned with continuing inflation. In addition, the Committee would lose a guide to policy implementation that, while difficult to employ at times, bears some leading, and also contemporaneous, relationship to economic behavior and which in that light--perhaps more usefully than the other aggregates--can be understood as calling for changes in money market conditions when it goes far astray.

The paper circulated to the Committee as background showed, among other things, that M1's relation to the economy has been loose in the sense that predicted changes in nominal GNP given the changes in M1 frequently have been wide of the mark in recent years. Still, even though such prediction errors have been rather large at times, there has been enough regularity about directional effects so as to make one wary of ignoring M1 entirely. That is, an acceleration or deceleration of M1 has more often than not been followed two quarters later by an acceleration or deceleration of nominal GNP growth--though the exact amounts of acceleration or deceleration have not corresponded well to prior M1 behavior.

If the Committee takes the view that an M1 range is not to be abandoned, the question arises about whether to raise the existing range and continue to apply it to the year as a whole, or whether to shift a range forward to a QII '85 base and have whatever range is chosen apply to the second half of the year. I am not very sure which of those two approaches would indicate more or less concern with M1, or more or less concern than the Committee may wish to signal. The act of raising the existing range would seem to suggest some determination to hit the new adjusted range--which would imply that the range should be rather clearly a realistic one. Shifting the base does not on the face of it provide a very different signal. It would seem to say the past is forgiven--as reflecting the impact on money demand of the effects of another notch down of interest rates, including lagged effects from last year. The Committee then would be providing its best estimate of appropriate growth over the balance of the year. One advantage of such an approach--no more than a symbolic one--would be that the Committee might not necessarily have to raise the existing 4 to 7 percent range, merely shift it forward.

However, our point estimate at the moment of M1 growth from QII '85 to QIV '85 is very near 7 percent at an annual rate, so that if the range were merely shifted forward to a QII base, without an upward adjustment there would be virtually no breathing room.

Whether the base were shifted forward, or the existing range raised, the present level of M1 would in any event be above such a new range. There is therefore the possibility that announcement effects of a new range might cause an unintended tightening of credit conditions, although that would in practice depend very much on the economic news also coming out at the time and, most importantly, on the words surrounding announcement of the ranges.

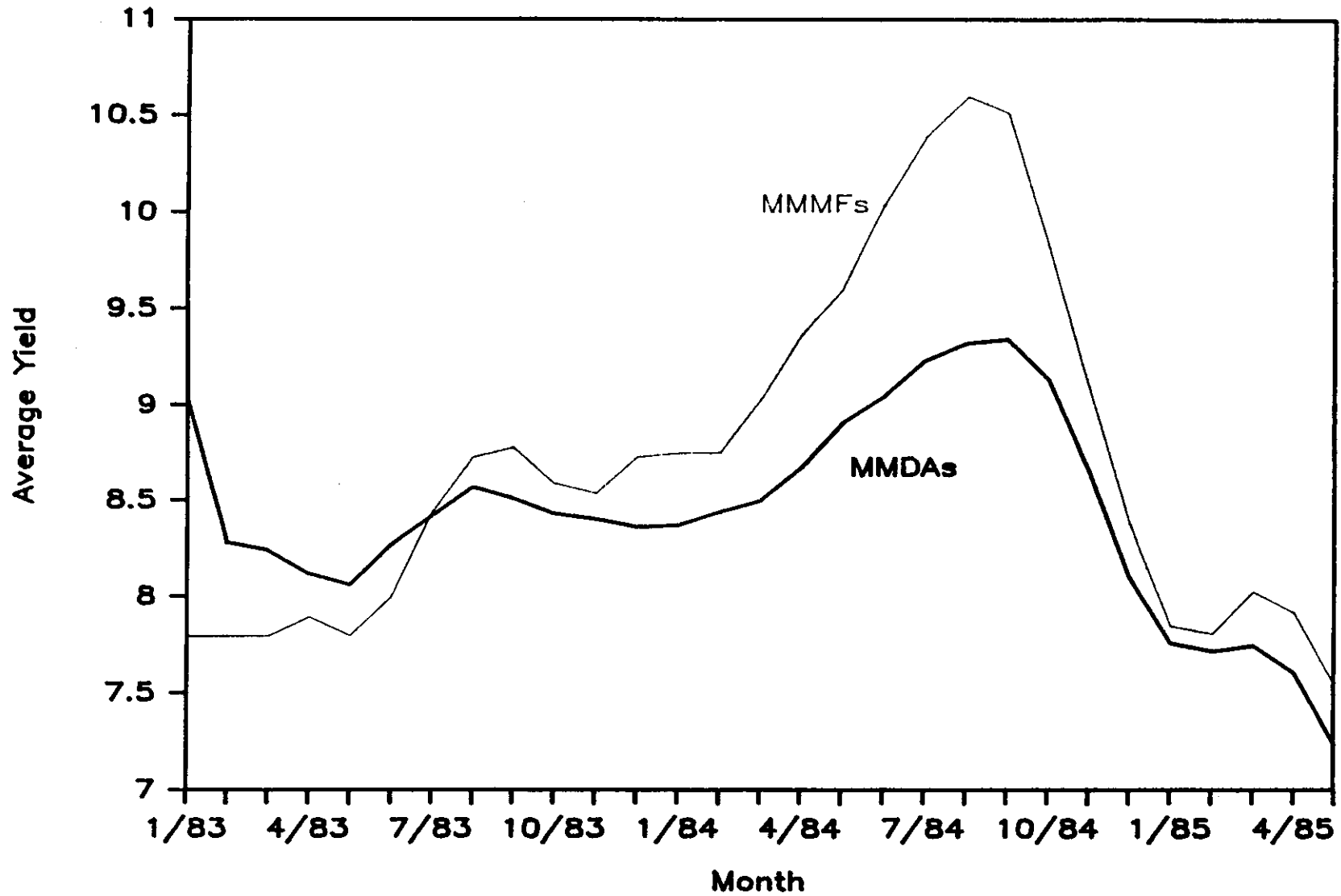
Depending in part on how much importance the Committee wishes to give to M1, a compromise between abandoning the range and setting a new range could be to retain the existing 4 to 7 percent based on QIV '84, indicate that the Committee expects or intends growth to slow in the second half of the year but further indicate that the Committee finds growth above the range acceptable for the year as a whole provided economic conditions permit, such as inflation remaining subdued. Such an approach is contained in proposal 2 for long-run directive language.

With respect to the tentative ranges for 1986, one basic question would seem to be whether the Committee wishes to signal its intent to continue with fostering progress toward reasonable price stability. The 1986 alternative III is one suggestion serving that end. The 3-1/2 percent lower limit of this M1 range, however, seems a bit unrealistic so far as can be foreseen now, and the Committee also may not wish to risk as large a downward adjustment in the range for the debt aggregate, given

recent experience, as is suggested in that alternative. Alternative I for 1986 would represent declines relative to current 1985 ranges for M3 and credit, and possibly also for M1 depending of course on the Committee's decision about adjusting the current M1 range.

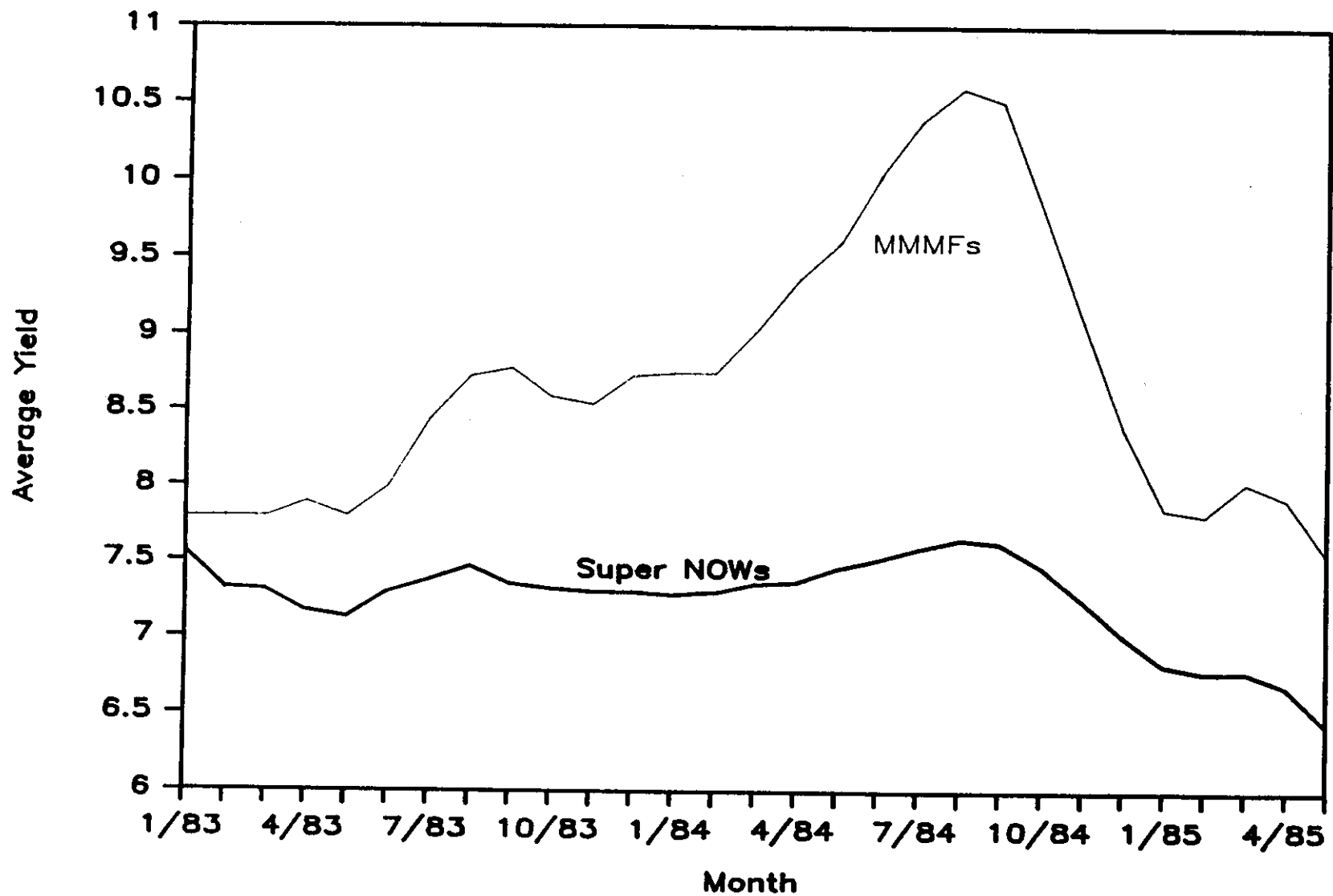
Finally, Mr. Chairman, whatever the choices made for the ranges this year and next, it would be desirable to keep before the public, in one way or another, the possibility that further downward movements of interest rates might entail increases in M1 and M2 above their ranges as investors shift savings out of market instruments and into depository institutions depending in part on how banks and thrift institutions adjust offering rates on deposits as market rates decline. Nominal interest rates could decline if and as inflationary expectations ebb. But they would also decline if the present level of real interest rates proves too high, given the exchange rate, to sustain real economic growth at a satisfactory pace. In that context, it can be observed that while real rates have dropped recently, and short rates are probably still somewhat above the range of variation during the 1950's and 1960's, real longer-term rates remain well above that range of experience.

MMDAs vs MMMFs

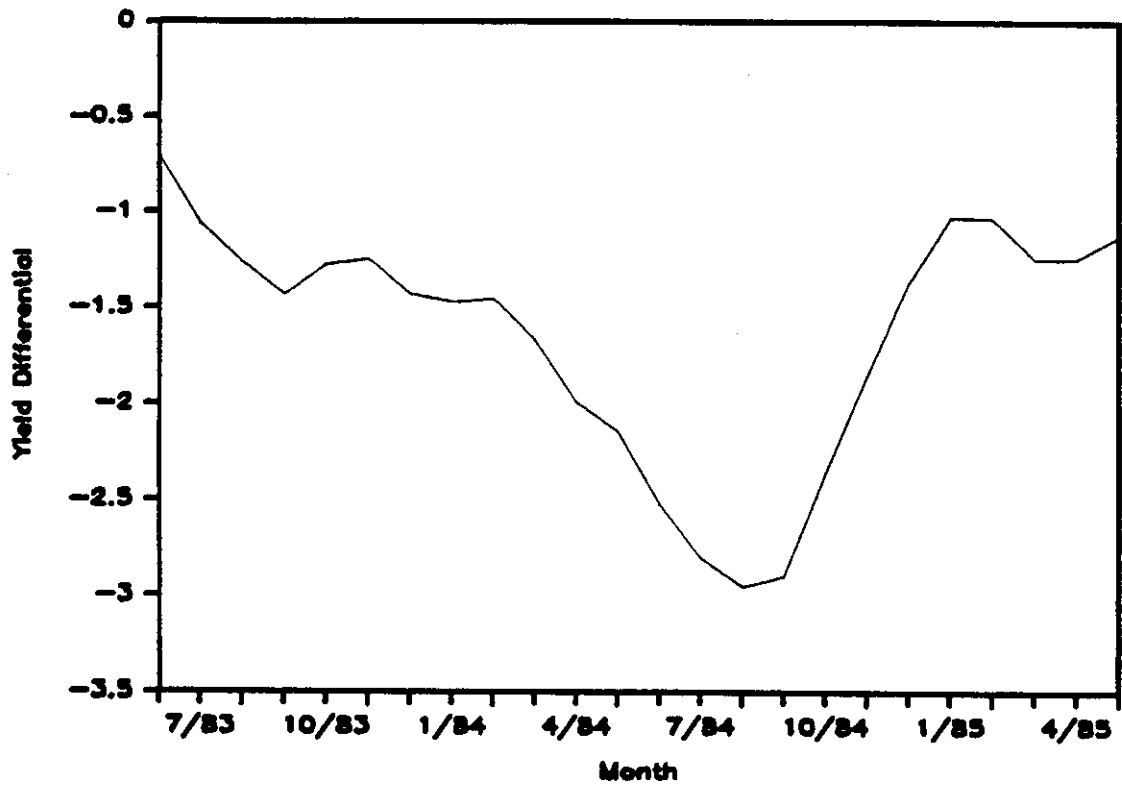


CHARTS AND TABLES
PREPARED BY MR. MORRIS
JULY 1985

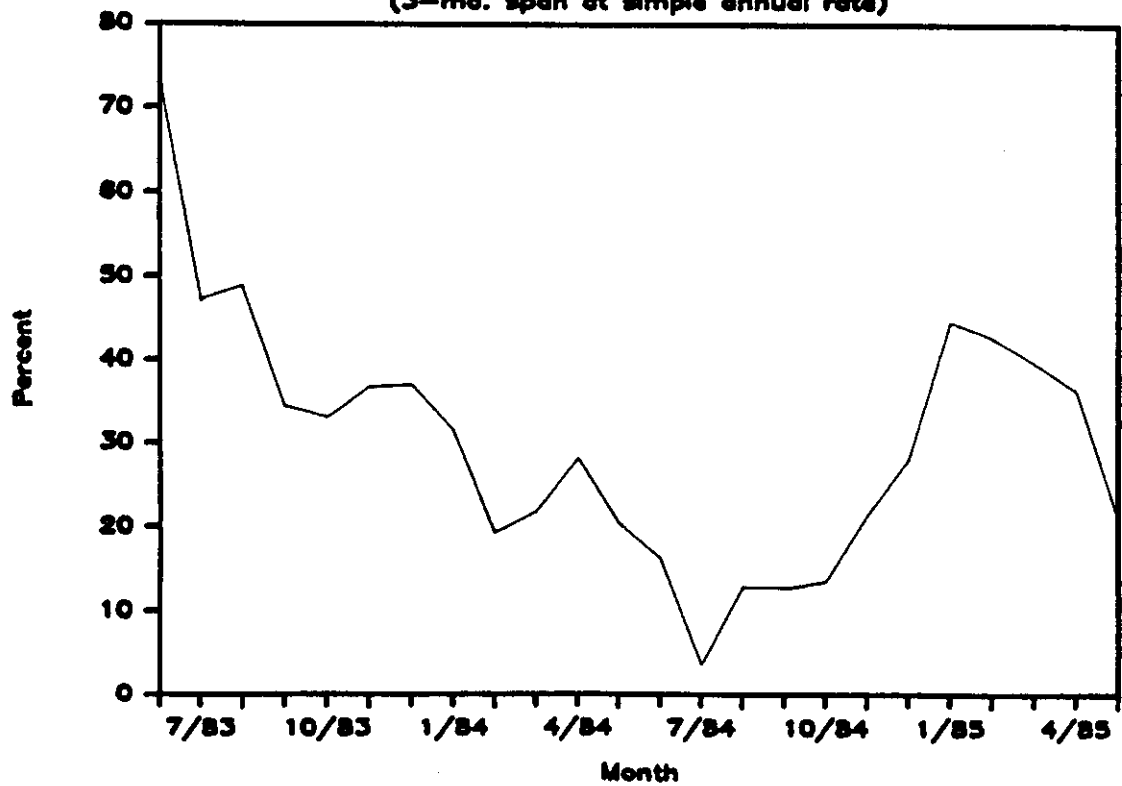
Super NOWs vs MMMFs



Super NOWs Less MMMFs



Growth Rate of Super NOWs (3-mo. span at simple annual rate)



Recent Behavior of Selected Velocities
Deviation from 1970-1980 Trends
(in percent)

	<u>M1</u>	<u>M2</u>	<u>M3</u>	<u>L</u>	<u>D</u>
1981:I	1.9	6.3	5.0	3.7	2.1
1981:II	0.3	5.1	4.8	2.9	1.3
1981:III	1.7	6.0	4.2	3.2	2.1
1981:IV	0.2	4.1	2.1	1.0	0.6
1982:I	-3.9	1.6	-0.2	-1.5	-1.6
1982:II	-3.4	1.0	-1.1	-2.6	-2.3
1982:III	-5.1	-0.8	-2.8	-4.4	-3.8
1982:IV	-9.1	-2.3	-3.9	-5.5	-5.2
1983:I	-10.7	-5.4	-4.3	-6.0	-5.4
1983:II	-11.7	-5.1	-3.4	-5.4	-4.9
1983:III	-12.7	-4.7	-3.0	-5.5	-5.2
1983:IV	-12.6	-4.3	-2.7	-5.1	-5.3
1984:I	-11.5	-2.7	-1.3	-4.3	-5.0
1984:II	-11.5	-1.9	-1.1	-4.6	-5.5
1984:III	-12.2	-2.3	-1.9	-6.1	-7.2
1984:IV	-12.1	-2.9	-2.7	-6.5	-8.7
1985:I	-14.3	-4.6	-3.8	-7.5	-10.6
Mean Absolute Error					
1970:I-1980:IV	1.0	2.2	2.2	1.6	0.7